Opus CAPITAL MANAGEMENT

Magnificent-7 Melt Up

Quick Look

» The most widely anticipated recession in recent memory has still not arrived. To this point at least, the dread that was all but certain for 2023 has yet to transpire.

» The entirety of the YTD S&P 500 Index returns has come, incredibly, from just seven mega-cap tech stocks. Through May 31, the remaining 493 companies in the Index collectively returned 0%.

» The current rally can be largely attributed to the belief that Artificial Intelligence could lead to a gold rush of earnings for Mega-Cap tech. We explain how AI could turn out to be as transformative as the Internet was in the late-1990s, and its victors could still be poor investments over the next decade.

» Evidence shows that the equity factors that we focus on perform best during recessionary periods, while market beta performs best during expansionary periods. Stronger than average market beta over the past 20 years helps explain the period's weaker factor returns.

» Rather than attempting to time markets based on volatile and lagging macro data, we suggest outcomes are better achieved through diversifying equity exposure among investment styles and remaining invested throughout the economic cycle.

» We tilt our equity allocations for portfolios towards evidence-based factors, but it is not a full bet, as we also recognize the compounding power of market beta. Simple market participation is all you have needed in 2023, in which seven stocks have comprised the entirety of returns.

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About Opus Capital Management

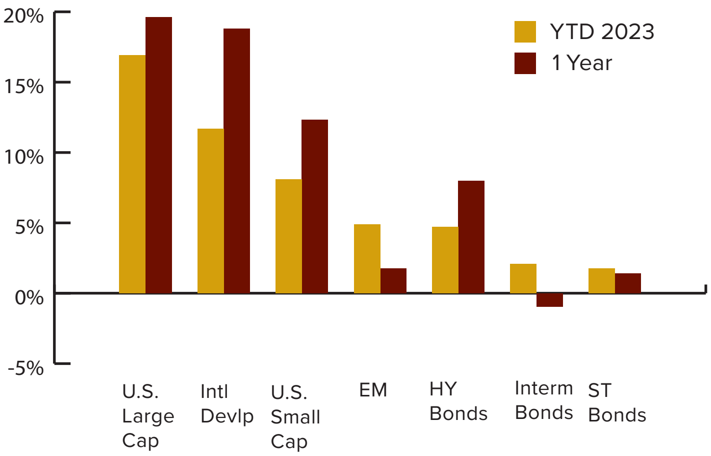
Opus Capital is an evidenced-based investment advisory firm driven by our overriding mission to help people. We believe the marriage of comprehensive financial planning + statistically proven investment principles creates the clearest roadmap to long-term success.

We are independent and transparent in all aspects of investment management decision making and financial planning. We selectively partner with like-minded individuals and families, endowments, foundations, and 401(k) plans in over 30 states.

Quarterly Investment Letter, Q2 2023

We are halfway through 2023, and markets are as confounding as ever. The most widely anticipated recession in recent memory has still not arrived. Consensus forecasts by Wall Street strategists called for a 2% decline for stocks this year (worth noting: the worst one-year forecast in 25 years), and yet, we sit at double-digit positive returns by June. To this point at least, the dread that was all but certain for 2023 has yet to transpire.

Asset Class Performance

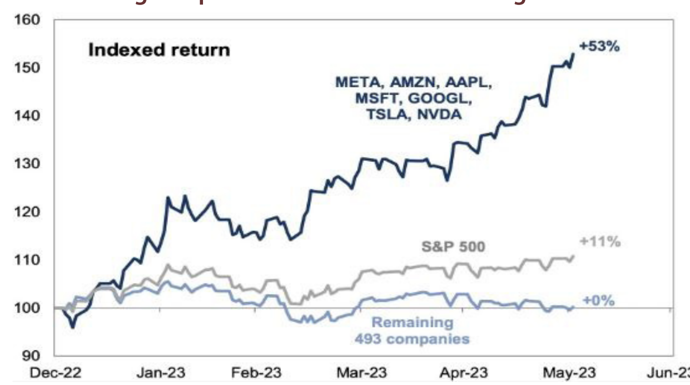


Source: Morningstar

Three quarters ago, the S&P 500 Index had declined 25% from highs, its ninth worst drawdown since 1950. Since that time, the S&P 500 Index is up more than 20%, officially registering as a new bull market. Interestingly, this equates to around the average recovery one-year later for the other eight drawdown of 25%+ magnitude since 1950. In one respect, the market's recovery can be explained by a commonality seen during deep drawdowns - stocks often turn on a change of beliefs well before a change in economic fundamentals.

The catalyst for year-to-date returns has been well documented, but as shown in the chart to the top-right, the entirety of the S&P 500 Index returns has come, incredibly, from just seven mega-cap tech stocks. Through May 31, the remaining 493 companies in the Index collectively returned 0%. It has been an extraordinary concentration of leadership within mega-cap Tech.

Mega-Cap Tech has Led the Market Higher YTD



Source: Factset, Goldman Sachs

The "Magnificent-7" (Apple, Microsoft, Amazon, Alphabet, Meta, Tesla, NVIDIA):

- These stocks now comprise 28% of the S&P 500 Index, the largest concentration of 7 stocks on record for the Index.
- These seven all trade on the NASDAQ and make up more than half of its Composite. Not coincidentally, the NASDAQ is up 32%, marking its best first-half performance since 1983.
- Thanks in large part to these seven, Large Cap Growth has outpaced Large Cap Value by 24% YTD, completely recovering its underperformance during 2022.
- Mega-cap stocks (i.e. Top 50) have beaten small cap stocks so far this year by the widest margin since the dot-com bubble.
- At 7.7%, Apple is the largest stock in S&P 500 since IBM's heyday 45 years ago. In fact, Apple's market capitalization is now larger than the entirety of the Russell 2000 Index (i.e., U.S. small cap stocks).

Mega-cap tech outperformance has been a recurring theme over the past half-decade, though the rationale has gone through at least three different iterations. The initial driver was the TINA market, which was the acronym to describe that there was no alternative to growth stock equities with cash rates at

U.S. EQUITY RETURNS (%)

As of 6/30/2023	Q2 2023	1-Year	3-Year	5-Year	10-Year
S&P 500	8.7	19.6	14.6	12.3	12.9
Russell 1000 (Large Cap) Growth	12.8	27.1	13.7	15.1	15.7
Russell 1000 (Large Cap) Value	4.1	11.5	14.3	8.1	9.2
Russell 2000	5.2	12.3	10.8	4.2	8.3
Russell 2000 (Small Cap) Growth	7.1	18.5	6.1	4.2	8.8
Russell 2000 (Small Cap) Value	3.2	6.0	15.4	3.5	7.3

Source: Morningstar

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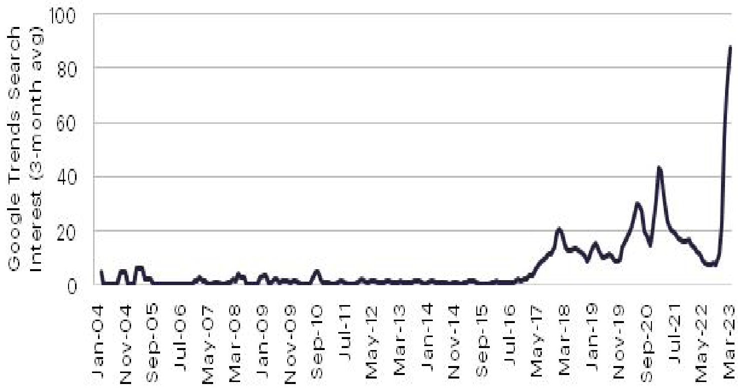
zero and bond yields near historic lows. Then, when COVID arrived, mega-cap tech names were temporarily considered safe stocks that could offer a pocket of stability during the shutdown.

Search Interest for "AI Stocks"



Source: Google

The current iteration can be partly attributed to the hype around Artificial Intelligence ("AI"). McKinsey released a report that estimated that Generative AI could add as much as $4 trillion worth of value to the global economy via productivity gains from automation of routine workers' tasks. The hope is that Generative AI could lead to a gold rush of earnings for mega-cap tech. Only time will tell if this comes to fruition, but its excitement has helped the S&P 500 recover all of its losses since the Fed's first rate hike in March of last year.

Historically, it is uncommon to see price multiples expand while the Fed is raising rates and financial conditions are tightening, particularly for long-duration risk assets like tech. However, that is exactly what occurred, as the average P/E ratio for the seven stocks has risen from 25x to 39x earnings since the start of the year. The remainder of the S&P 500, meanwhile, trades at 16x.

The top stock this year has been chip designer NVIDIA, whose 190% YTD gains have recently pushed its market cap above $1 trillion. The stock most supercharged by the AI frenzy, NVIDIA stands out from the other six as its earnings expectations since the start of the year have exploded (earnings are expected to triple by 2025). NVIDIA's valuation ratios are now sky-high, most notably its price-to-sales ratio, which is at an eye-catching 40x, whereas the average P/S for the other six trade at a more palatable premium of 7x. A 40x multiple on sales harkens back to dot-com days, where valuations proved too extreme for even the winners. It took Microsoft 16 years and Oracle 17 years to eclipse their Year 2000 stock prices, despite strong average annual sales growth during that time. Cisco still trades below its Year 2000 high, even though sales have grown on average 25% annually. The lesson here is that AI could turn out to be as transformative as the Internet was in the late-1990s, and its victors could still be poor investments over the next decade.

Post Dot-Com Era Performance

	Max Drawdown	Recovery Year	Years to Recover	Price/Sales Year 2000	Average Sales Growth
Microsoft (MSFT)	-67%	2016	16	31x	28%
Oracle (ORCL)	-83%	2017	17	51x	24%
Cisco (CSCO)	-86%	N/A	N/A	35x	25%

Source: Factset

Factors through Economic Cycles

A recent research paper from David Blitz of Robeco found that equity factors generate most of their raw return in bear markets. Mispricing typically builds during bull markets (resulting in weaker factor returns) and tends to get corrected in bear markets (resulting in large factor payoffs). Our internal research corroborates this data. The table below provides the excess monthly returns for selected factors by economic cycle dating back to 1963. As you can see below represented by the green cells, the Value, Profitability, Investment (as measured by Fama-French) and Quality (as measured by AQR) are all strongest either pre-recession or during a recession. Their weakest periods of returns, highlighted in red cells, are all during periods when the economy is expansion or early expansion.

Excess Monthly Factor Returns by Economic Cycle

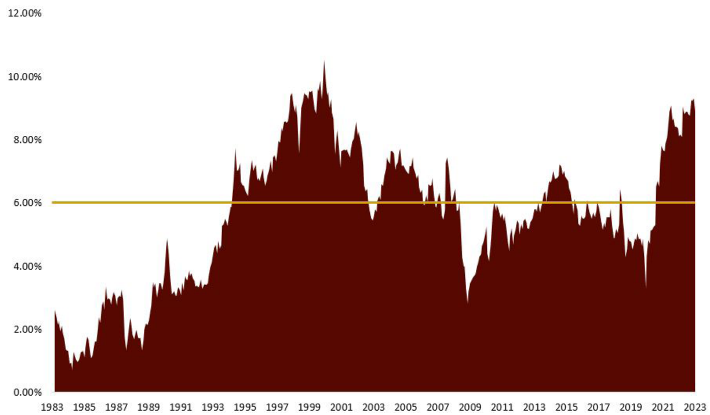
Economic Cycle	Market Beta	Value	Profitability	Investment	Quality
Expansion	0.90	0.24	0.15	0.15	0.29
Pre-Recession	-0.18	0.41	0.66	0.41	0.77
Recession	-0.88	0.37	0.47	0.75	0.91
Early-Expansion	1.12	0.36	0.40	0.35	0.02

Source: Fama French, AQR

Conversely, we also found that market beta (returns above the risk-free rate) provides its highest returns in early expansion and expansion periods. During pre-recession and recession periods, the market's average monthly returns have trailed the risk-free rate. One can extrapolate this data to conclude that during economic expansions and/or bull markets, investors can generate double digit positive annual returns with simple passive beta exposure to the market. Nothing fancy is needed during these periods; simple index funds will capture the predominance of returns. Mispricing, however, will build within markets during these periods, and eventually become exposed during recessions and/or bear markets, at which point factor-based strategies prove their mettle. This certainly held true in 2022; while the market underperformed cash by 21%, the factors noted in the table above all delivered meaningfully positive relative outperformance.

Another interesting finding from Robeco's paper was that, when looking at the last 60 years of returns, markets had been in a bear market 27% of the time before 2004, but only 9% of the time since 2004. Their conclusion is that decay in recent factor performance may be partly attributed to the market being in a predominantly bullish state, an environment that tends to be less favorable to raw factor returns. During the last 20 years, annual market returns have been 9% higher than cash returns. Historically, stocks return 6% above cash. Stronger than average market beta over the past 20 years helps explain the period's weaker factor returns.

Rolling 20-Year Market Beta



Source: Fama French

Macro Perspective

Our best guess is that a recession still looms. The yield curve is deeply inverted, rates are sharply higher, and the impact is still working through the economy as monetary policy is lagging. The money supply is shrinking, and banks are shuttering credit. Surveys are signaling contraction, as are leading indicators. Europe is in a recession. The debt ceiling deal amounted to mostly political theatre, but will curtail government spending by 0.25% of GDP. Student loans repayments will start back up and will reduce consumer spending.

But the economy has been resilient, even showing improvements in places. Jobs refuse to roll over, and the NBER is not going to label this period a recession so long as job gains continue. Consumer spending remains robust, even as it works through excess COVID cash and starts to increase credit card balances. Autos sales have picked up. Housing numbers look better. Neither should be increasing in front of a recession.

Is it possible the two negative quarters in 2022, which are often thought of a recession, was the nadir? Both the 2001 and 2008 recessions had 20% bull market rallies sandwiched in between two bear markets. But these rallies began after recessions had already arrived, and both fizzled within one quarter. This current rally is now three quarters long. Any bets made on this rally would have likely been on the presumption of Fed rate cuts, not an AI frenzy.

The challenge with incorporating macro data into portfolio implementation is that timing is extremely difficult, as the point the gears change in economic cycles is often only known in hindsight. Economic data is often lagging, volatile, and frequently prone to revisions. The pandemic effects have only exacerbated these issues. Recessions are only labeled as such months after they have arrived, and therefore provide no leading investment signal. As an example, the recession during the GFC started in December 2007, but was not technically declared a recession until December 2008. Rather than attempting to time markets based on volatile and lagging macro data, we suggest outcomes are better achieved through diversifying equity exposure among investment styles and remaining invested throughout the economic cycle.

We believe the information above helps to provide rationale to our portfolio construction. Within U.S. stocks, roughly 60% of our model weighting is to index funds, which we believe are the cheapest mechanism to capture market beta tax-efficiently. The other 40% is invested in factor-based strategies that focus on the factor premia outlined above, which, along with Shareholder Yield, tend to outperform during more turbulent times. We have conviction that this combination of core exposure with diversified factor titling provide favorable odds of outperformance through a full economic cycle. Estimations of economic cycles can be helpful in a general sense, but bets should be sized in accordance with uncertainty rather than an all-or-nothing approach. For example, we increased our factor-based weighting this quarter, but only by 5% of our models.

In summary, we tilt our equity allocations for portfolios towards evidence-based factors, but it is not a full bet, as we also recognize the compounding power of market beta. Simple market participation is all you have needed in 2023, in which seven stocks have comprised the entirety of returns.

INTERNATIONAL RETURNS (%)

As of 6/30/2023	Q2 2023	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	3.0	18.8	8.9	4.4	5.4
Emerging Markets	0.9	1.8	2.3	0.9	3.0

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 6/30/2023	Q2 2023	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	-0.8	-0.9	-4.0	0.8	1.5
Muni	0.0	2.6	-0.5	1.4	2.1
Int'l Bonds	-0.8	0.8	-3.6	-1.0	-0.2
High-Yield	1.5	8.0	3.1	2.8	3.5
Short-Term	0.1	1.4	-0.4	1.3	1.3
90-Day T-Bill	1.3	4.4	1.6	1.7	1.1

Source: Morningstar

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